INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	2
Argument	7
Conclusion	13
Appendix	14

CITATIONS

Cases:	
Commissioner v. *Lincoln Electric Co.*, 176 F. 2d 815, certiorari denied, 338 U. S. 949	11
Commissioner v. *Surface Combus. Corp.*, 181 F. 2d 444	12
Fairless v. *Commissioner*, 67 F. 2d 475	9
Harrison v. *Commissioner*, 173 F. 2d 736	9
Leighton v. *United States*, 289 U. S. 506	8
National Carbide Corp. v. *Commissioner*, 336 U. S. 422	12
Phillips v. *Commissioner*, 283 U. S. 589	8, 9, 10
Phillips-Jones Corp. v. *Parmley*, 302 U. S. 233	9
Pierce v. *United States*, 255 U. S. 398	9
Scott v. *Commissioner*, 117 F. 2d 36	8, 9
Smith v. *Commissioner*, 11 T. C. 174	13
Surface Combustion Corp. v. *Commissioner*, 9 T. C. 631, affirmed, 181 F. 2d 444	11
United States v. *Armstrong*, 26 F. 2d 227	9
United States v. *Updike*, 281 U. S. 489	8
Updike v. *United States*, 8 F. 2d 913, certiorari denied, 271 U. S. 661	9
Statutes:	
Internal Revenue Code:	
Sec. 23 (26 U. S. C. 1946 ed., Sec. 23)	10, 11, 14
Sec. 165 (26 U. S. C. 1946 ed., Sec. 165)	11, 15
Sec. 311 (26 U. S. C. 1946 ed., Sec. 311)	8, 16
Revenue Act of 1942, c. 619, 56 Stat. 798:	
Sec. 162 (26 U. S. C. 1946 ed., Secs. 23, 165)	11, 17
Miscellaneous:	
Treasury Regulations 103:	
Sec. 19.23 (a)–1	22
Sec. 19.23 (a)–6	22
Sec. 19.23 (p)–1	24
Sec. 19.23 (p) (1)–1	11, 25
Sec. 19.165–1	27
Sec. 19.165 (a) (1)–1	11, 12, 28

Miscellaneous—Continued

	Page
Treasury Regulations 111:	
Sec. 29.23 (a)–1	24
Sec. 29.23 (a)–6	24
Sec. 29.23 (p)–1	27
Sec. 29.165–1	30

In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 545

CHARLES E. SMITH AND SONS COMPANY, HALL C. SMITH, TRANSFEREE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 308–337) and the order modifying them (R. 340–342) are unreported. The opinion (R. 376–379) of the Court of Appeals is reported at 184 F. 2d 1011.

JURISDICTION

The judgment of the Court of Appeals was entered on October 20, 1950. (R. 375–376.) A petition for rehearing was denied on November

21, 1950 (R. 391.) The petition for a writ of certiorari was filed on February 10, 1951. The jurisdiction of this Court is invoked under the provisions of 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

1. Whether transferee liability was properly upheld against Hall C. Smith, for unpaid taxes of the corporate taxpayer for the fiscal year ending July 31, 1943, under Section 311 of the Internal Revenue Code. This in turn depends upon whether distributions made to him by the company had the effect of rendering it insolvent.

2. Whether the corporate taxpayer should be allowed a deduction for sums paid out pursuant to its pension trust plan under Section 23(p) of the Code.

3. Whether the corporate taxpayer should have been allowed to deduct the full amount paid Smith, its sole-shareholder president, as salary under Section 23(a) of the Code.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and regulations involved are set forth in the Appendix, *infra,* pp. 14–30.

STATEMENT

The facts as found by the Tax Court may be summarized as follows:

Charles E. Smith & Sons Company (hereinafter referred to as the corporation) is an Ohio corporation. Hall C. Smith (hereinafter referred

to as Smith) at all times material hereto was president of the corporation and owner of all its capital stock. (R. 309.)

The corporation was organized in 1904, with capital stock of $40,000 divided into 400 shares, for the purpose of dealing in and manufacturing men's shirts, and dealing in men's clothing and other wearing apparel. In 1905, the capital stock was reduced to $30,000. Smith first became connected with the corporation in 1924, when he was elected president, the corporation having previously been owned and operated by his parents and other relatives. From September 19, 1914, until November 15, 1929, the only entries in the minute books of the corporation are with respect to the years 1924 and 1925. There was one minute entry covering a meeting held on November 15, 1929. From November 15, 1929, until October 1941, there are no minute entries in the corporation's books. (R. 310.)

Smith acquired all the capital stock in 1941. In 1942, he acquired all of an additional 300 share issue of $30,000, which the corporation redeemed at par value. (R. 310.)

Prior to the taxable years, the corporation was a small manufacturer of men's shirts, also operating a retail men's furnishing store. The shirt factory had six employees, the store, four. In 1940, being unable to meet payments to its creditors, the corporation filed a petition under Chapter XI of the Bankruptcy Act, as amended, for

arrangement with the creditors. The court-approved plan scaled down to 35 percent the corporation's debts, providing for 15 percent payment in cash, 20 percent in two promissory notes. Total payment was made and a final report was made to the District Court on July 24, 1942. (R. 311.)

In June or July of 1941, Smith commenced to make an effort, in which he was successful, to secure some war work. Two large contracts were secured, one in October 1941, and one in April 1942, to manufacture Army tow targets from material supplied by the Air Corps. The corporation subsequently also entered into a supplying contract with the Navy, and into a small contract with the Quartermaster Corps, as well as some small subcontracts. (R. 311–312.)

At a stockholders' meeting of the corporation dated October 1941, a resolution was adopted increasing Smith's salary to $52,000 per year, Smith being the only stockholder present, and also being cognizant that the corporation was low bidder on the first Air Corps' contract. (R. 312.) In years prior to those involved, Smith's salary had ranged between $4,800 and $7,500 (R. 327), except for 1937, in which year Smith received $10,800 (R. 314). A board of directors resolution in September 1942, provided for a salary for Smith of 15 percent of net sales, not to exceed any Governmental limitation, but not to be less than the $52,000 salary already set. (R. 312.)

To carry out the war contracts, new machines were purchased, as well as a new building, the purchase of which Smith arranged. Smith worked long hours, sometimes sixteen or eighteen a day, and finding some changes necessary in Air Corps' blueprints, in accordance with which the tow targets were manufactured, he travelled considerably to secure approval of his suggested changes. (R. 312–313.)

From the fiscal year ending July 31, 1936, to that ending in 1941, the corporation's net sales ranged between $90,700 (1937) and $38,800 (1941). In the fiscal year ending in 1942, its sales jumped to $369,800; in 1943, to $581,800. The increase in sales was due entirely to war contracts. (R. 314–315.)

The corporation paid Smith $52,000 as salary for the year ending July 31, 1942, and $87,265.08 for that ending in 1943. The Tax Court found that a reasonable allowance for salary for the two years was $25,000 and $30,000, respectively. (R. 315.)

In 1942, the corporation entered into a "pension trust agreement" with Smith, and two others as trustees. It was to provide pensions in the form of annuity payments upon retirement of employees, and death benefits. (R. 315–316.) The agreement provided that the corporation should designate the original beneficiaries and the amounts of pension to be provided for each of them; Smith was included among the em-

ployees affected by the plan. (R. 316.) The pension trust was never approved by the Commissioner of Internal Revenue. (R. 322.) A table showing salaries of each employee and contributions made for each in the taxable years involved appears in the record. (R. 322–323.) The contributions paid by the corporation were paid to a Canadian company in 1942 and 1943. The corporation was unable to make its contribution in 1944, and, as a result, the trust agreement was terminated by it, the contracts held thereunder being assigned and distributed free from the trust to the then participants therein. (R. 324.)

Between 1944 and 1945, the corporation ceased all its operations. The mortgage on its new building was foreclosed and the property sold, satisfying the first mortgage and a second mortgage held by Smith. The remainder of the proceeds, totaling $30,485.89, is in the hands of the sheriff of Hamilton County, Ohio. A decree of confirmation of the foreclosure, sale, and distribution has been entered by the county court. (R. 325–326.)

Upon the facts, the Tax Court decided, as noted above, that a reasonable allowance for services rendered by Smith was $25,000 and $30,000 for the two fiscal years, respectively. It also held that no deduction for payments to the pension trust should be allowed, because the test of reasonableness of the amounts as compensation for personal services rendered had not been met.

Third, it held Smith liable as transferee for the corporation's taxes for the fiscal years ending in 1942 and 1943, because distributions made to him in the fiscal year ending in 1943 (to be described below) made the corporation insolvent. (R. 326–337.)

After the Tax Court had handed down its memorandum findings of fact and opinion (R. 308–337), on the corporation's motion (R. 337–339) it handed down an order (R. 340–342), amending its opinion. The effect of the amendment was to limit Smith's liability as transferee to the amount of the distribution of $57,265.08 made to him by the corporation for the fiscal year ending in 1943 (that being the portion of the salary paid him during that year which was held to be in excess of reasonable compensation for services), whereas in the original opinion the Tax Court had held him liable also with respect to the payment received in 1943 in redemption of stock.

The corporation and Smith appealed to the Court of Appeals for the Sixth Circuit which affirmed the decision of the Tax Court. (R. 375–379.)

ARGUMENT

1. Petitioners contend that the court below erred in charging Smith with transferee liability (Br. 4–7). Petitioners' argument on this contention is not entirely clear, but it appears to rest on two propositions, (1) the corporation was not

934090—51——2

insolvent as late as July 31, 1943; and (2) Smith's salary was paid by installments, not in a lump sum, thus bringing insolvency by degrees rather than at once. On the latter point, petitioners assert conflict between the decision below and *Phillips* v. *Commissioner,* 283 U. S. 589, and *Scott* v. *Commissioner,* 117 F. 2d 36 (C. A. 8).

Upon the findings made by the Tax Court (R. 334–337, 341–342) that the corporation was insolvent as of July 31, 1943, and that its insolvency resulted from the distribution to Smith of the $57,265.08 (the portion of the $87,265.08 salary paid to him during the year which was in excess of reasonable compensation), the court below correctly upheld the decision of the Tax Court (R. 357) that Smith is liable as transferee to the extent of $57,265.08 (R. 379). It is well settled that the Government by suit in equity or proceeding under Section 311 of the Internal Revenue Code, *infra,* pp. 16–17, can recover from distributees or recipients of corporate assets of an insolvent corporation the value of what they received, in order to discharge any taxes assessed against the corporation. *Phillips* v. *Commissioner, supra; United States* v. *Updike,* 281 U. S. 489; *Leighton* v. *United States,* 289 U. S. 506; *Scott* v. *Commissioner, supra.* In holding Smith liable as transferee, the Tax Court correctly recognized that, in determining the question of insolvency, a liability for taxes unknown at the time of distribution must be taken into account. *Scott* v. *Commis-*

sioner, supra. It has been repeatedly held that a subsequently levied tax is a potential liability of the corporation of which the stockholders must take notice. *Scott* v. *Commissioner, supra; United States* v. *Armstrong,* 26 F. 2d 227, 231 (C. A. 8); *Updike* v. *United States,* 8 F. 2d 913 (C. A. 8), certiorari denied, 271 U. S. 661.

Petitioners argue (Br. 6) that the holding of transferee liability in excess of the insolvency was erroneous. But the transferee liability runs to the full extent of the assets received (*Phillips* v. *Commissioner, supra; Phillips-Jones Corp.* v. *Parmley,* 302 U. S. 233; *Pierce* v. *United States,* 255 U. S. 398; *Fairless* v. *Commissioner,* 67 F. 2d 475 (C. A. 6); *Harrison* v. *Commissioner,* 173 F. 2d 736 (C. A. 5)), limited, of course, to the amount of tax due.

Clearly, there is no conflict, as claimed, with *Scott* v. *Commissioner, supra,* relative to the parcelling out of assets in installments. First, the language quoted by the taxpayers from the *Scott* opinion (Br. 5) is obviously dicta, since the quotation itself shows that no such distributions were made in that case. Secondly, the real answer is that there is no showing of any "parcelling out" of assets to Smith in installments in the instant case (cf. R. 315), and, further, there is no support in the record for the petitioners' claim (Br. 6) that "some $35,265.08 remained unpaid" on July 31, 1943. In any event, whether payments to Smith were made by installment or

not, the corporation, which was wholly owned and controlled by Smith, did make payments of salary to him which had the effect of rendering it insolvent. Under the circumstances, Smith's transferee liability is plain. Similar considerations apply with respect to the alleged conflict (Br. 6–7) between the decision of the court below and *Phillips* v. *Commissioner, supra.*

2. Petitioners further argue (Br. 8–9) that error was committed below in disallowing the deductions from gross income sought for payments made pursuant to the pension trust plan. On this question the court below correctly affirmed the Tax Court, which had held that the contributions for both taxable years would be deductible only if they constituted proper deductions under Section 23 (a) of the Code, and met the test of reasonableness thereunder. (R. 331.) The Tax Court further pointed out that the contributions to the pension trust made by the corporation during the first taxable year are not deductible under Section 23 (p) as originally enacted as part of the Code, because they were payments representing current pension liability for that taxable year, and Section 23 (p) then permitted the deductions of amounts paid only with respect to pension liability applicable to other years or amounts paid to place the trust on a sound financial basis. (R. 332–333.) As to the contributions paid to the pension trust during the second taxable year, the Tax Court correctly in-

terpreted Section 23 (p), as amended by Section 162 of the Revenue Act of 1942, *infra,* pp. 17–22, as requiring that in order for a contribution to be deductible under Section 23 (p) it must meet the test of deductibility under Section 23 (a), even though the deduction, if any, must be taken under Section 23 (p) and not under Section 23 (a). (R. 331, 333.)

It is clear that the test of reasonableness must be met in order for contributions to a pension trust to be deductible under Section 23 (a). See Section 19.23 (p) (1)–1 of Treasury Regulations 103 *infra,* pp. 25–27. *Surface Combustion Corp.* v. *Commissioner,* 9 T. C. 631, 656, affirmed, 181 F. 2d 444 (C. A. 6); *Commissioner* v. *Lincoln Electric Co.,* 176 F. 2d 815 (C. A. 6), certiorari denied, 338 U. S. 949. The conclusion of the Tax Court that the corporation had failed to meet the burden resting upon it of establishing the reasonableness of the amounts paid is, upon the record, correct, and was properly sustained below.

Moreover, as held by the court below, the contributions were not in any event deductible because the trust did not meet the requirements of Section 165 of the Internal Revenue Code, *infra,* pp. 15–16. The trust was not for the exclusive benefit of the employees, because of the inclusion of Smith within its operation. Section 19.165 (a) (1)–1 of Treasury Regulations 103, *infra,* pp. 28–30. Also, as one of the trustees under the

trust, empowered under the trust agreement (paragraph (e) of Art. *Eighth,* R. 55) to act for all three trustees, Smith as sole shareholder and obviously in control of the corporation, could easily have administered the trust in a manner other than for the exclusive benefit of the employees. Cf. *Commissioner* v. *Surface Combus. Corp.,* 181 F. 2d 444, 447 (C. A. 6).

Further, because there was little likelihood that the corporation would be able to continue the making of large payments to the pension trust after completing its war work, the plan would not qualify under Section 165 because of a lack of "permanency." See Section 19.165 (a) (1)–1 of Treasury Regulations 103, *infra,* pp. 28–30.

3. Petitioners' final argument (Br. 9–11) is not clear. First, it is contended that the court below did not pass upon the claim that Smith could elect to operate part of the business as a corporation and part of it individually. The short answer thereto is that Smith ran the entire business as a corporation and cannot now escape the consequences of that choice. *National Carbide Corp.* v. *Commissioner,* 336 U. S. 422, 438–439. And that is also the answer to the computation submitted by the taxpayers (Br. 10) which apparently seeks to show that Smith should pay less taxes than he is required to pay by the decision below. Moreover, it should be noted that in a separate proceeding in the Tax Court involving the personal income tax liability

of Smith for the year 1943, the Tax Court held that Smith was not liable for income taxes on the amount of excessive compensation received by him for 1943 with respect to which he had been held liable herein as transferee for the unpaid taxes of the corporation. *Smith* v. *Commissioner,* 11 T. C. 174. Review of that decision is pending in the Court of Appeals for the Sixth Circuit, but it has been agreed that no further action therein shall be taken pending the outcome of the instant proceeding.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.
THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
HARRY MARSELLI,
EDWARD J. P. ZIMMERMAN,
Special Assistants to the Attorney General.

MARCH, 1951.

APPENDIX

INTERNAL REVENUE CODE

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(p) *Pension Trusts.*—

(1) *General Rule.*—An employer establishing or maintaining a pension trust to provide for the payment of reasonable pensions to his employees shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive

years beginning with the year in which the transfer or payment is made.

* * * * *

(3) *Exemption of trusts under section 165.*— The provisions of paragraphs (1) and (2) of this subsection shall be subject to the qualification that the deduction under either paragraph shall be allowable only with respect to a taxable year (whether the year of the transfer or payment or a subsequent year) of the employer ending within or with a taxable year of the trust with respect to which the trust is exempt from tax under section 165.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 165 [As amended by Sec. 218 of the Revenue Act of 1939, c. 247, 53 Stat. 862]. EMPLOYEES' TRUSTS.

(a) *Exemption From Tax.*— A trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of some or all of his employees—

(1) if contributions are made to the trust by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, and

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees,

shall not be taxable under section 161, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits against net income such part of the amount so distributed or made available as represents the items of interest specified in section 25 (a).

* * * * *

(26 U. S. C. 1946 ed., Sec. 165.)

SUPPLEMENT N—CLAIMS AGAINST TRANSFEREES AND FIDUCIARIES

SEC. 311. TRANSFERRED ASSETS.

(a) *Method of Collection.*—The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) *Transferees.*—The liability, at law or in equity, of a transferee property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

(2) *Fiduciaries.*—The liability of a fiduciary under section 3467 of the Revised Statutes, as

amended (U. S. C., Title 31, § 192), in respect of the payment of any such tax from the estate of the taxpayer.

Any such liability may be either as to the amount of tax shown on the return or as to any deficiency in tax.

* * * * *

(26 U. S. C. 1946 ed., Sec. 311.)

REVENUE ACT OF 1942, C. 619, 56 STAT. 798

SEC. 162. PENSION TRUSTS.

(a) *Exemption of Trusts.*—Section 165 (relating to employees' trusts) is amended to read as follows:

"SEC. 165. EMPLOYEES' TRUSTS.

"(a) *Exemption From Tax.*—A trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall not be taxable under this supplement and no other provision of this supplement shall apply with respect to such trust or to its beneficiary—

"(1) if contributions are made to the trust by such employer, or employees, or both, for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

"(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes

other than for the exclusive benefit of his employees or their beneficiaries;

"(3) if the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

"(A) 70 per centum or more of all the employees, or 80 per centum or more of all the employees who are eligible to benefit under the plan if 70 per centum or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding five years, employees whose customary employment is for not more than twenty hours in any one week, and employees whose customary employment is for not more than five months in any calendar year, or

"(B) such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees; and

"(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

* * * * *"

(b) *Deduction Allowed Employer.*—Section 23 (p) (relating to deduction for amounts paid to pension trusts) is amended to read as follows:

"(p) *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.*—

"(1) *General rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent:

"(A) In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year ends within or with a taxable year of the trust for which the trust is exempt under section 165 (a), in an amount determined as follows:

"(i) an amount not in excess of 5 per centum of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust, but such amount may be reduced for future years if found by the Commissioner upon periodical examinations at not less than five-year intervals to be more than the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan, plus

"(ii) any excess over the amount allowable under clause (i) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Commissioner with the approval of the Secretary, but if such remaining unfunded cost with respect to any three individuals is more than 50 per centum of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years, or

"(iii) in lieu of the amounts allowable under (i) and (ii) above, an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Commissioner with the approval of the Secretary, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 per centum of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan, as determined under regulations prescribed by the Commissioner with the approval of the Secretary, except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.

"(iv) Any amount paid in a taxable year in excess of the amount deductible in such year un-

der the foregoing limitations shall be deductible in the succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year in accordance with the foregoing limitations.

"(B) In the taxable year when paid, in an amount determined in accordance with subparagraph (A) of this paragraph, if the contributions are paid toward the purchase of retirement annuities and such purchase is a part of a plan which meets the requirements of section 165 (a), (3), (4), (5), and (6), and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year towards the purchase of such retirement annuities.

* * * * *"

(d) *Taxable Years to Which Amendments Applicable.*—The amendments made by this section shall be applicable as to both the employer and employees only with respect to taxable years of the employer beginning after December 31, 1941, except that—

(1) In the case of a stock bonus, pension, profit-sharing, or annuity plan in effect on or before September 1, 1942,

(A) such a plan shall not become subject to the requirements of section 165 (a) (3), (4), (5), and (6) until the beginning of the first taxable year beginning after December 31, 1942,

(B) such a plan shall be considered as satisfying the requirements of section 165 (a) (3), (4), (5), and (6) for the period beginning with the beginning of the first taxable year following

December 31, 1942, and ending December 31, 1943, if the plan satisfies such requirements by December 31, 1943,

(C) if the contribution of an employer to such a plan in the employer's taxable year beginning in 1942 exceeds the maximum amount deductible for such year under section 23 (p) (1), as amended by this section, the amount deductible in such year shall be not less than the sum of—

(i) the amount paid in such taxable year prior to September 1, 1942, and deductible under section 23 (a) or 23 (p) prior to amendment by this section, and

(ii) with respect to the amount paid in such taxable year on or after September 1, 1942, that proportion of the amount deductible for the taxable year under section 23 (p) (1), as amended by this section, which the number of months after August 31, 1942, in the taxable year bears to twelve.

* * * * *

(26 U. S. C. 1946 ed., Secs. 23, 165.)

TREASURY REGULATIONS 103, PROMULGATED UNDER THE INTERNAL REVENUE CODE

Sec. 19.23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *

Sec. 19.23 (a)–6. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allow-

ance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a con-

tingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.[2]

Sec. 19.23 (p)-1 [As amended by T. D. 5278, 1943 Cum. Bull. 478, 491]. *Payments to Employees' Pension Trusts for Taxable Years Beginning Prior to January 1, 1942.*—An employer who adopts or has adopted a reasonable pension plan, actuarially sound, and who establishes, or has

[2] Provisions similar to the above quoted portions of Sections 19.23 (a)-1 and 19.23 (a)-6 are contained in the subsequent Treasury Regulations relating to the income tax under the Internal Revenue Code, Treasury Regulations 111, in Sections 29.23 (a)-1 and 29.23 (a)-6, respectively.

established, and maintains a pension trust for the payment of reasonable pensions to his employees (if the trust is exempt from tax under section 165, relating to trusts created for the exclusive benefit of employees) shall be allowed to deduct from gross income reasonable amounts paid to such trust, in accordance with the pension plan (including any reasonable amendment thereof), as follows:

(a) If the plan contemplates the payment to the trust, in advance of the time when pensions are granted, of amounts to provide for future pension payments, then (1) reasonable amounts paid to the trust during the taxable year representing the pension liability applicable to such year, determined in accordance with the plan, shall be allowed as a deduction for such year as an ordinary and necessary business expense, and in addition (2) one-tenth of a reasonable amount transferred or paid to the trust during the taxable year to cover in whole or in part the pension liability applicable to the years prior to the taxable year, or so transferred or paid to place the trust on a sound financial basis, shall be allowed as a deduction for the taxable year and for each of the nine succeeding taxable years.

* * * * *

Sec. 19.23 (p) (1)–1 [As added by T. D. 5278, *supra*, p. 492]. *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred Payment Plan.—In general.*—Section 23 (p), as amended, prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity,

stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 23 (p) does not cover contributions or compensation which give the employee or former employee present benefits such as life insurance protection. The cost of such benefits is deductible to the extent allowable under section 23 (a). See section 19.165 (b)–1. Section 23 (p), however, is applicable to all contributions under a stock bonus, pension, profit-sharing, or annuity plan, whether or not the employee's rights in such contributions are nonforfeitable.

A contribution to be deductible under section 23 (p) must be an ordinary and necessary expense which would be deductible under section 23 (a) if it were not for the fact that the statute specifically provides that it shall be deductible under section 23 (p). A contribution by a corporation under a plan which is created primarily for the purpose of benefiting shareholders of the company is not deductible. Such contribution may constitute a dividend within the meaning of section 115 (a). A contribution under a plan that is set up for the exclusive benefit of employees as such, and thus represents an item of expense, is of the nature of compensation for personal services rendered by the employees covered by the plan. The amount of contributions allowable as a deduction has an over-all limitation—the entire contributions for the taxable year when added to other compensation paid must represent

reasonable compensation for services rendered by the employee beneficiaries.[3] * * *

* * * * *

SEC. 19.165–1 [As amended by T. D. 4973, 1940–1 Cum. Bull. 65, and T. D. 5278, *supra,* p. 480]. *Employees' Trusts for Taxable Years Beginning Prior to January 1, 1942.*

(*a*) *Plans and trusts for employees.*—A "stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of some or all of his employees" is a definite written program and arrangement communicated to such employees, solely designed and applied to enable such employees to share in the capital or profits of such employer's trade or business or to provide for the livelihood of such employees upon their retirement from employment. A "trust forming part of a stock bonus, pension, or profit-sharing plan" is a trust formed and availed of solely to aid in the proper execution of one of the plans defined in the preceding sentence. This phrase includes only trusts created for the exclusive benefit of employees, and does not include devices for distributing profits to shareholders. All the surrounding and attending circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees within the meaning of section 165.

(*b*) *Taxable years beginning prior to January 1, 1940.*—A trust forming part of a plan defined

[3] Provisions similar to the quoted portons of section 19.23 (p) (1)–1 are contained in Treasury Regulations 111, in Section 29.23 (p)–1.

in paragraph (*a*) is exempt for taxable years beginning prior to January 1, 1940, if: (1) contributions are made to the trust by such employer, such employees, or both; and (2) such contributions are made for the purpose of distributing to such employees both the earnings and principal of the fund accumulated by the trust; and (3) the fund is accumulated by the trust in accordance with the plan of which the trust is a part.

(*c*) ***Taxable years beginning after December 31, 1939.*** A trust forming part of a plan defined in paragraph (*a*) is exempt for taxable years beginning after December 31, 1939, if all three tests designated in paragraph (*b*) as (1), (2), and (3) are met; and if also (4) the trust instrument makes it impossible (in the taxable year and at any time thereafter prior to the satisfaction of all liabilities to employees covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees.

* * * * *

SEC. 19.165 (a) (1)–1 [As added by T. D. 5278, *supra*, p. 480]. ***Employees' Trusts for Taxable Years Beginning After December 31, 1941.***—(*a*) ***In general.***—In order that a trust may be exempt under section 165 (a) it must be part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries. The trust must be formed and availed of solely to aid in the proper execution of a plan which is a definite written program and arrangement communicated to the employees, solely designed and applied to enable such em-

ployees or their beneficiaries to share in the capital or profits of such employer's trade or business or to provide for the livelihood of such employees or their beneficiaries after the retirement of such employees.

The term "plan" implies a permanent as distinguished from a temporary program. While the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, if the plan is abandoned for any cause other than business necessity within a few years after it has taken effect, this will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true in the case of a pension plan under which pensions were fully funded for the highly paid employees or others in favor of whom discrimination is prohibited under section 165 (a), and which was abandoned soon after the pensions for such favored employees had been provided. The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the event a plan is abandoned, the employer should promptly notify the Commissioner, stating the circumstances which led to the discontinuance of the plan.

If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, even if other employees who are not shareholders are included under the plan, it will not qualify as a plan for the *exclusive* benefit of employees. The plan must benefit the employees

in general, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan is not for the exclusive benefit of employees in general if it discriminates either in eligibility requirements, contributions, or benefits by any device whatever in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 165 (a) (3), (4), and (5). All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not so much with the form of any plan as it is with its effects in operation. For example, in section 165 (a) (5) the law specifies certain provisions, which of themselves are not discriminatory, but this does not mean that a plan containing these provisions may not be discriminatory in actual operation.[4]

* * * * *

[4] Provisions similar to the quoted portions of Section 19.165 (a) (1)–1 are contained in Treasury Regulations 111, in Section 29.165–1.

U. S. GOVERNMENT PRINTING OFFICE: 1951

No. 443.

In the

Supreme Court of the United States

CHARLES E. SMITH AND SONS COMPANY,
Hall C. Smith, Trustee,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPLICATION FOR REHEARING

SOL. GOSSMAN,
1016 Union Trust Building,
Cincinnati, Ohio,
Attorney for Petitioners.

COURT INSERT PRESS, INC. · LAW PRINTERS · CINCINNATI, OHIO

No. 545

In the
SUPREME COURT OF THE UNITED STATES

CHARLES E. SMITH AND SONS COMPANY,
Hall C. Smith, Transferee,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPLICATION FOR REHEARING

Petitioners respectfully request a rehearing.

In the brief filed by respondent, certain statements were contained which are incorrect and may have mislead the Court into refusing the petition. On page 9 of respondent's brief, the statement is made as follows:

> "Secondly, the real answer is that there is no showing of any 'parcelling out' of assets to Smith installments in the instant case (cf. R. 315), and, further, there is no support in the record for the petitioners' claim (Br. 6) that 'some $35,265.08 remained unpaid' on July 31, 1943."

How can respondent honestly argue to this Court that there is no showing of "parcelling out" if the tax court found that the *payment was made over a period of* 13 *months?* (R. 315).

The record showed that petitioner's salary was to be no less than $52,000 per annum, but equal to 15% of net sales.

The $52,000 per annum (R. 312) either was or could have been paid during the 12 months period of the fiscal year ending July 31, 1943, and the balance of $35,265.08, remained unpaid on July 31, 1943, and was paid by Sept. 1, 1943.

The statements and contentions of the respondent as contained in his brief were definitely erroneous, contrary to the findings of the Lower Court as contained in the record, and certainly misleading. For this if for no other reason, a rehearing and reconsideration should be granted and had in this case. The decision of the Court, refusing the petition for a writ of certiorari, which results in the affirmance of the Lower Courts is a grave injustice and is in direct opposite to this Court's decision in the case of *Phillips* v. *Commissioner,* 283 U. S. 589.

Respondent's argument in his brief (page 13) that in a separate proceeding the tax court had ordered a refund of taxes paid on the excessive salary, is misleading. Respondent had contended that such refund is improper and his appeal is still pending in the Court of Appeals.

For the foregoing reasons, the petition for rehearing and reconsideration should be granted.

Respectfully submitted,

SOL GOODMAN,
1016 Union Trust Building,
Cincinnati, Ohio,
Attorney for Petitioner.

CERTIFICATE

I, Sol Goodman, counsel for petitioners, hereby certify that this petition for rehearing is filed in good faith; that I believe the decision herein is unjust and that the Court has been misled in reaching its decision by mis-statements in the brief of respondent; and that this is not filed for the purpose of delay.

SOL GOODMAN,
1016 Union Trust Building,
Cincinnati, Ohio,
Attorney for Petitioners.